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PROTECTION FOR DEBENTURE HOLDERS

SEVERAL spectacular collapses of top-heavy corporate structures have recently revealed the dubious character of safety provisions in debentures.[1] Debentures have been widely used,[2] and they may perform an economic service in increasing the variety of media for financing. They provide the issuing corporation greater freedom in the control of its assets than do mortgage bonds, and command smaller return than preferred stock, being theoretically less in risk. Debentures typically are unsecured obligations,[3] but various devices have been used in the attempt to increase their apparent security. These devices often take the form of covenants between the issuer and the holder, or the issuer, holder and a trustee.[4] One such covenant, commonly called the nega-

1. See notes 14, 22, 25, 60, and 64, *infra*.

2. An analysis of domestic debentures listed in MOODY'S MANUALS OF INDUSTRIALS, PUBLIC UTILITIES, and BANKS AND FINANCE for the years 1929, 1930, and 1931, prepared for Prof. Saxon of Yale shows 845 issues in existence during this period.

3. DEWING, FINANCIAL POLICY OF CORPORATIONS (3d ed. 1934) 105; STETSON ET AL., 1 SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION, AND REGULATION (1930) 66–69. In this Comment, no attempt is made at a narrow definition of "debenture". It is not a term of art, but is used loosely to cover several types of corporate security. See WALMSLEY, COMPANY LAW (1931) 111; 1 QUINDRY, BONDS AND BONDHOLDERS (1934) § 5.

4. Of the 845 debenture issues mentioned in note 2, *supra*, 577 contained some sort of restrictive covenant.

tive pledge clause, is a promise by the issuing corporation not to pledge or mortgage any of its assets; the promise is normally either absolute, prohibiting all such pledges and mortgages, or restricted to a prohibition of pledging or mortgaging without allowing the debenture holders an equal lien.[5] Often loans for less than one year, contracted in the usual course of business, are excepted from the scope of the negative pledge clause.[6] Another common covenant is a promise by the issuer not to incur any obligations which would cause its total indebtedness to exceed a specified percentage of the value of its assets.[7] Violation of these covenants may accelerate the maturity date of the issue. As a further protection, a bank is often made trustee of the issue under an indenture.[8] Some "debentures" are secured by deposit of collateral with the trustee.[9] Usually a broad power of substitution of collateral is retained by the issuer, and the duties ordinarily imposed upon the trustee by the trust indenture are negligible. Furthermore, indentures almost invariably extend to trustees immunity from liability arising from all contingencies except gross negligence or bad faith.[10]

Restrictive covenants and trust indentures, nominally written for the protection of debenture holders, are drafted by the issuer, who is interested in retaining a maximum of control over its assets, by the trustee, who seeks to avoid the imposition of liability, and by the house of issue, which is primarily interested in marketability.[11] Indentures are lengthy, formidable documents, and covenants are couched in technical and involved language. Since these provisions could be understood by few investors, and since, in any event, the purchase of securities by well-informed investors is based chiefly on an analysis of the earning position of the issuer, rather than on covenants or other contractual provisions, there is practically no pressure of purchaser opinion to improve these covenants. The position of the purchaser of such deben-

5. This promise may take the affirmative form, *i.e.*, a promise to give debenture holders an equal lien if assets should be pledged or mortgaged.

6. Good examples are set out in Kelly v. Central Hanover Bank & Trust Co., 11 F. Supp. 497, 502, n.2 (S. D. N. Y. 1935); Chase National Bank v. Sweezy, 281 N. Y. Supp. 487, 490 (Sup. Ct. 1931); SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PART VI, TRUSTEES UNDER INDENTURES (1936) 10, n.17.

7. See Kelly v. Central Hanover Bank & Trust Co., 11 F. Supp. 497, 502, n.3 (S. D. N. Y. 1935); DEWING, *op. cit. supra* note 3, at 108.

8. A situation described in Chase National Bank v. Sweezy, 281 N. Y. Supp. 487 (Sup. Ct. 1931); Kaplan v. Chase National Bank, 156 Misc. 471, 281 N. Y. Supp. 825 (Sup. Ct. 1934); Gardiner, *Corporate Bonds, Mortgages, Collateral Trusts, and Debenture Indentures*, 27, in 8 SOME LEGAL PHASES OF CORPORATE FINANCING (1931).

9. Of the 845 debenture issues mentioned in note 2, *supra*, 44 were secured in some manner.

10. See note 62 *infra* and S. E. C. *op. cit. supra* note 6, at 68, 69.

11. S. E. C., *op. cit. supra* note 6, at 5; and see Green v. Title Guarantee and Trust Co., 223 App. Div. 12, 16, 227 N. Y. Supp. 252, 257 (1st Dep't, 1928), *aff'd*, 248 N. Y. 627, 162 N. E. 552 (1928).

tures is analogous to that of a purchaser of a railroad ticket containing clauses exempting the carrier from liability,[12] or that of an insured accepting the provisions of a policy carefully drawn by the insurer.[13] Courts and legislatures have seen fit to protect the individual from the injury to which his obviously unequal bargaining position exposes him in the latter two instances, and recent developments indicate the necessity for such protection in the case of debenture holders. The debenture holder may attempt to enforce the rights nominally assured him by contract in a variety of actions, few of which promise success.

Where a negative pledge clause is relied upon, and no trustee exists for the protection of the debenture holders, the first problem facing the debenture holder who would bring any type of suit is that of whether the negative pledge covenant has been violated. In *Kelly v. Central Hanover Bank & Trust Company*[14] one of the holders of $66,000,000 of debentures of the Insull Utilities Investment, Inc., brought a class suit to recover assets of that company which had been pledged with banks as security for short-term loans of $17,000,000 contracted in 1931, or alternately, to be secured in those assets equally and ratably with the banks. The debentures contained a prohibition against the pledge of assets unless the debentures were ratably scured[15] and an absolute restriction upon borrowings in excess of 50% of the value of the assets of the issuer.[16] The debentures provided that the principal amount would become due if a violation of any of the covenants continued for 60 days. No provision was made for a trustee of these debentures. The theory of the plaintiff's action, brought after the I. U. I. collapse in 1932, was that the loans from the banks had violated the 50% clause of the debentures and that the pledge of stock securing those loans violated the negative pledge clause, which violations, plaintiff argued, entitled her in equity to recover from the banks, which allegedly knew of the restrictions in the debentures. Judge Mack held that neither covenant had been violated.

The negative pledge clause in question provided that: "The company hereby covenants . . . that . . . it will not mortgage or pledge any of its property unless the instrument creating such mortgage or pledge shall provide that this debenture shall be secured thereby equally and ratably with all other obligations issued or to be issued thereunder, except that the company without so securing this debenture (a) may at any time mortgage or pledge any of its property for the purpose of securing loans to the company

12. GODDARD, OUTLINES OF THE LAW OF BAILMENTS AND CARRIERS (2d ed. 1928) § 266; HUTCHINSON, CARRIERS (3d ed. 1906) § 450.

13. See Patterson, *Administrative Control of Insurance Policy Forms* (1925) 25 COL. L. REV. 253. For statutory definition of contract terms in mortgages and bonds, see N. Y. REAL PROPERTY LAW, § 254.

14. 11 F. Supp. 497 (S. D. N. Y. 1935). Discussed in Comments (1936) 49 HARV. L. REV. 620, (1935) 30 ILL. L. REV. 487, (1936) 22 VA. L. REV. 440; and Note (1936) 36 COL. L. REV. 319.

15. *Id.* at 502, n. 2.

16. *Id.* at 502, n. 3.

contracted in the usual course of business for periods not exceeding one year . . ." Judge Mack held that the clause clearly referred to the creation of a funded debt secured by a mortgage or trust instrument. Since the short term bank loans did not fall within the prohibition of the clause so construed, the pledge of stock to secure those loans did not violate the covenant. Under this interpretation of the negative pledge clause Judge Mack was compelled to hold that the exception of loans made "in the usual course of business" was surplusage and could have no application to the facts of the *Kelly* case.[17]

Upon appeal, the Circuit Court of Appeals cast considerable doubt upon Judge Mack's interpretation of the negative pledge clause.[18] That court remanded the case to the court below for findings upon two issues on which Judge Mack had not passed, one of which was whether the loans to the banks were made in the ordinary course of business. The request by the Circuit Court of Appeals for a finding on this issue suggests that Judge Mack's interpretation of the negative pledge clause as applying only to funded indebtedness might be overruled; for the provision allowing loans in the usual course of business, as an exception to the negative pledge clause, becomes pertinent only if the court regards the loans as otherwise within the prohibition of the covenant. The determination of whether these loans were or were not in the usual course of business[19] will require careful analysis of the circumstances under which these loans were incurred, against the background of the financial latitude required by the I. U. I., a top holding company, in its major activity of raising funds and trading in large blocks of stocks, often representing the effective control of operating companies.[20]

Action predicated upon the violation of the 50% clause presents further difficulties. The I. U. I. covenanted with its debenture holders that "it will not create or assume any additional indebtedness if as a result thereof

17. *Id.* at 504.

18. 85 F. (2d) 61 (C. C. A. 2d, 1936). In an intermediate decision [14 F. Supp. 346 (S. D. N. Y. 1936)] Judge Mack held that since a trial judge was not required to make findings on all questions presented by evidence, a statement of evidence is properly prepared under Equity Rule 75 if it contains only evidence essential to findings and conclusions of the trial judge.

19. Comment (1936) 49 HARV. L. REV. 620, 622. The similar exception of notes maturing within not more than one year, upon which the defendant relied in Kaplan v. Chase Nat. Bank, 156 Misc. 471, 281 N. Y. Supp. 825 (Sup. Ct. 1934) was easily dismissed by Steuer, J.: "Defendant claimed that the demand notes were paid by the $10,000,000 note, and hence there was no outstanding indebtedness for a year. Under the circumstances, the question is undoubtedly one of intent. The intent found here was one to avoid the provisions of the indentures which was accomplished by stamping the notes paid and indulging in the other mummeries of banking practice".

See the interpretation of usual course of business in Wheatley v. Silkstone & Haigh Moor Coal Co., 29 Ch. D. 715 (Ch. D. 1885) (no negative pledge covenant); Brunton v. Electrical Engineering Corp. [1892] 1 Ch. 434 (Ch. D. 1891); *In re* Automatic Bottle Makers, Ltd. [1926] 1 Ch. 412 (C. A.).

20. For a description of the regular cycle in which I. U. I. operated, see Comment (1936) 22 VA. L. REV. 440, 443.

its total indebtedness will exceed 50% of the then value of its assets". Most of the bank loans at issue in the *Kelly* case were used to pay off existing indebtedness of the I. U. I., and as to them Judge Mack held that the 50% clause was not violated since in a refinancing operation no "additional indebtedness" is created.[21] A further difficulty in proving the violation of a 50% clause is the question of proof of the value of assets of the issuer, a question involving complex and technical accounting problems.

Transferring assets to and between subsidiaries in order to circumvent negative pledge clauses makes proof of violation even more difficult than in the *Kelly* case. An issue of $25,000,000 of debenture bonds by the Paramount-Publix Corporation[22] provided that "So long as any of the Bonds shall be outstanding the Corporation will not create, or permit the creation of, any mortgages or other lien upon any property or assets directly owned by the Corporation, without equally and ratably securing the Bonds thereunder".[23] In 1932 Paramount-Publix had a large stock of film under production, but was without the working capital to finish the pictures. In order to obtain a loan of $4,275,000 from various banks for this purpose and to secure existing short term loans of $9,600,000, the corporation transferred the assets relating to the films to a subsidiary created for the sole purpose of holding them, and this subsidiary paid the parent for these assets by notes which the parent endorsed to the banks. This transaction technically did not constitute a violation of the negative pledge clause, for no mortgage or lien had been created upon any assets. The notes of the subsidiary which Paramount-Publix endorsed to the banks were unsecured promises payable generally out of the assets of the subsidiary. But the only assets of the subsidiary were those which had been transferred to it by Paramount-Publix to give substance to its promise to the banks. The obligation of the subsidiary to the banks gave the banks a direct claim upon those assets in case of default, and in this manner the debenture holders were neatly and effectively insulated from the assets upon which Paramount-Publix had promised not to place any mortgage or other lien.[24]

The Securities and Exchange Commission's investigation of the reorganization of the Cuban Cane Sugar Corporation revealed another indirect circumvention of a negative pledge clause through the manipulation of subsidiaries.[25] In 1920 Cuban Cane issued $25,000,000 of debentures containing a restrictive clause covenanting not to create any mortgage or lien on its property except in the acquisition of properties or in renewals of existing

21. 11 F. Supp. 497, 506 (S. D. N. Y. 1935).

22. S. E. C., *op. cit. supra* note 6, at 11.

23. *Id.* at 10, n. 17.

24. The debenture holders were further "protected" in this case by the existence of an indenture and a trustee, the Chase Bank. But the Chase Bank was a trustee without substantial duties, and was under no obligation to act nor did it act for the debenture holders in this instance. *Id.* at 13.

25. *Id.* at 98.

liens. At that time Cuban Cane was the sole stockholder of the Violet Sugar Company, the principal asset of which was the Violetta Mill, one of the most valuable sugar properties in Cuba. In 1921 the price of sugar dropped from 21 to 1½ cents a pound. As conditions imposed by New York banks to secure a $10,000,000 rescue loan, in that same year holders of $17,800,000 of the debentures agreed to subordinate their claims and Cuban Cane agreed to pay off the loan by the flotation of mortgage bonds.[26] Pursuant to this agreement Cuban Cane caused Eastern Cuba Sugar Corporation, another wholly owned subsidiary, to issue $10,000,000 of mortgage bonds which were sold by Cuban Cane to its stockholders and underwriters. These mortgage bonds were secured in part by the Violetta Mill, which Cuban Cane had caused to be transferred from the Violet Company to Eastern Cuba for this purpose. Since the Violetta Mill had been owned through a subsidiary and not directly by Cuban Cane, counsel were confident that the negative pledge clause was not being violated.[27] Nonetheless the fact remains that in spite of the safety provisions of the debentures a valuable asset held by a wholly owned subsidiary of Cuban Cane at the time the debentures were issued was subjected to a mortgage two years later without ratably securing the debenture holders. Some light upon the effectiveness of the negative pledge clause in this situation is shed by the fact that in 1935 debenture holders were offered the alternative of becoming stockholders in a reorganized company by the payment of $10 a share or of receiving $2.50 or $3.00 in full settlement for each $1000 debenture, while bank creditors whose short term loans were secured emerged with ownership of the new company.[28] The *Paramount-Publix* and *Cuban Cane* cases present graphically the sharp conflict of interest between the issuer and debenture holders where, on the one hand, a negative pledge clause purports to restrict the issuer in the control of its assets, and, on the other, the exigencies of business demand the pledge of those assets;[29] and furthermore, indicate a technique whereby issuers may perhaps circumvent such clauses with impunity.

Although the transfer of assets to a subsidiary for the purpose of giving certain creditors a preferred status with respect to those assets accomplishes the same result as a direct pledge of the assets to the creditors, the legal grounds upon which such a transaction can be voided are most uncertain. In a few cases where assets were transferred to a subsidiary solely for the purpose of preferring certain creditors, courts have treated the assets of the subsidiary as indistinguishable from those of the parent in order to permit the creditors of the parent to share ratably with the creditors of the subsidiary

26. Proceedings before the S. E. C. In the matter of Cuban Cane Sugar Corporation (1935) at 58.

27. *Id.* at 70–77.

28. S. E. C., *op. cit. supra* note 6, at 93.

29. *Id.* at 13, 99.

in those assets.[30] On the other hand, courts have also refused to disregard the corporate entity of the subsidiary where the forms of corporate activity and of the transfer were meticulously followed.[31] And in a very recent case, although the court decided to disregard the corporate entity of the subsidiary, its creditors were allowed to recover in full on the theory that their action in accepting the substitution of the subsidiary as a debtor was beneficial to the corporation in a period of stress.[32]

But assuming that the debenture holder can prove a clear violation of the negative pledge clause, his troubles have then just begun. If by some chance he has discovered the intent of the issuer to violate the covenant before the transaction is completed and, instead of selling his debenture, decides to incur the expense of suit, it is doubtful whether he is entitled to an injunction, or must wait for the violation to be completed and then sue for damages.[33] The provision for acceleration of the debenture because of a violation may prevent the granting of an injunction.[34] These questions are not likely to be settled because the fact of violation seldom becomes known to debenture holders until it is fully consummated. Then the remedy against the issuer, either of damages or of acceleration, if provided, is clearly obtainable, but seldom of any value because the facts revealing the violation usually become known only when the issuer is insolvent.

There remains to be considered only the remedy against the pledgees who took assets in violation of the covenant, which must consist of something in the nature of an equitable lien upon these assets in favor of the debenture

30. Hamilton Ridge Lumber Sales Corp. v. Wilson, 25 F. (2d) 592 (C. C. A. 4th, 1928); First Nat. Bank of Durham v. Raleigh Savings Bank & Trust Co., 37 F. (2d) 301 (C. C. A. 4th. 1930) (stock of subsidiary pledged as collateral); *cf.* N. Y. Trust Co. v. Island Oil & Transport Co., 56 F. (2d) 580 (C. C. A. 2d, 1932) (no intent to prefer subsidiary's creditors).

31. Carson v. Long Bell Lumber Corp., 73 F. (2d) 397 (C. C. A. 8th, 1934); Wagoner v. Wallace Turnbull Corp., 306 Pa. 442, 160 Atl. 105 (1932); First Nat. Bank of Seattle v. Walton, 146 Wash. 367, 262 Pac. 984 (1928).

32. Commerce Trust Co. v. Woodbury, 77 F. (2d) 478 (C. C. A. 8th, 1935); *cert. denied* 296 U. S. 614 (1935), modifying Woodbury v. Pickering Lumber Co., 10 F. Supp. 761 (W. D. Mo. 1933), (1936) 45 YALE L. J. 717.

33. In Holmes v. St. Joseph Lead Co., 84 Misc. 278, 147 N. Y. Supp. 104 (Sup. Ct. 1914) *aff'd* 163 App. Div. 885, 147 N. Y. Supp. 1117 (1914), stockholders sued to enjoin the sale of a debenture issue which would have given the company power to violate an earlier negative pledge covenant, but the court held that no rights under the negative pledge covenant were violated until the power was exercised. It would appear clear, however, that an injunction against a pledge under a complete negative pledge clause, or specific performance of an agreement to allow an equal lien, would be decreed if suit were brought before the rights of third parties were involved. See Connecticut Co. v. N. Y., N. H. & H. R. R. 94 Conn. 13, 45, 107 Atl. 646, 657 (1919); Knott v. Shepherdstown Mfg. Co., 30 W. Va. 790, 796, 5 S. E. 266, 269 (1888).

34. See Kelly v. Central Hanover Bank & Trust Co., 11 F. Supp. 497, 510 (S. D. N. Y. 1935) and cases there cited.

holders.[35] An equitable lien is a remedial device which has been used to establish claims against specific property in the most diverse situations.[36] It may be enforced against a person making a promise, or whose acts give rise to an implied promise, upon which the lien is based.[37] Such a lien is good against anyone but an innocent purchaser without notice, and can be proved in bankruptcy against the trustee, whose status under the Bankruptcy Act does not carry immunity against such equities.[38] Thus the lienor may obtain a preferance as against other general creditors, who had no knowledge of the facts upon which the lien was based, but who are, in the judgment of the court, less entitled to a claim against the particular asset to which the lien is attached.[39]

In the *Kelly* case, Judge Mack concluded that the debenture covenants did not give rise to an equitable lien, or any other kind of equitable charge on the assets in favor of the debenture holders.[40] His opinion does not seem clearly to distinguish the several related situations in which equitable liens have been considered, nor to exploit adequately the promise of the cases with respect to the issue. While it is often said that a promise not to do something with respect to property does not give the promisee a claim to the property,[41] a promise with affirmative implications, like a promise to secure

35. Throughout this discussion, it should be kept in mind that, if the covenants were avoided by a transfer of assets to a subsidiary, the only way in which the debenture holders might be restored to their protected position is by disregarding the corporate entity of the subsidiary, *supra* notes 30, 31, and that once this is done there is no question of equitable lien, since creditors of subsidiary and parent share equally in the assets of both. But see note 32, *supra*.

36. Britton, *Equitable Liens—A Tentative Analysis of the Problem* (1930) 8 N. C. L. REV. 388; Comments, (1931) 31 COL. L. REV. 1335; (1934) 32 MICH. L. REV. 685.

37. Connecticut Co. v. N. Y., N. H. & H. R. R., 94 Conn. 13, 107 Atl. 646 (1919). A common example is the support and maintenance case. McKnight v. McKnight, 212 Mich. 318, 180 N. W. 437 (1920).

38. Voltz v. Treadway & Marlatt, 59 F. (2d) 643 (C. C. A. 6th, 1932); Tobin v. Insurance Agency Co., 80 F. (2d) 241 (C. C. A. 8th, 1935). But see Penn Lumber Co. v. Wilson, 26 F. (2d) 893, 895 (C. C. A. 4th, 1928).

39. A closely analogous situation appears in the English law of floating charges as applied to debenture issues. These charges fix upon insolvency, and give the debenture holders a lien superior to that of general creditors. *In re* The Panama, New Zealand, and Australian Royal Mail Co., Ltd. L. R. 5 Ch. App. 318 (Ch. 1870); *In re* Florence Land and Public Works Co., 10 Ch. D. 530 (C. A. 1878); *In re* Colonial Trusts Corporation, 15 Ch. D. 465 (M. R. 1879); Wheatley v. Silkstone & Haigh Moor Coal Co., 29 Ch. D. 715 (Ch. D. 1885); Robson v. Smith [1895] 2 Ch. 118 (Ch. D.); Government Stock & Other Sec. Inv. Co. v. Manila Ry. Co., Ltd., [1897] A. C. 81 (H. L. 1896); *In re* Borax Co. [1899] 2 Ch. 130 (Ch. D.); Evans v. Rival Granite Quarries, Ltd. [1910] 2 K. B. 979 (C. A.); *In re* Crompton & Co., Ltd. [1914] 1 Ch. 954 (Ch. D.)

40. 11 F. Supp. 497, 507, 511 (S. D. N. Y. 1935). The minor grounds of the opinion, that the defendant was not liable for non-inducing breach of contract nor for participating in a breach of trust, are not discussed here, as they do not seem to raise any possibilities of recovery by debenture holders.

41. Knott v. Shepherdstown Mfg. Co., 30 W. Va. 790; 5 S. E. 266 (1888); B. Kuppenheimer & Co. v. Mornin, 78 F. (2d) 261 (C. C. A. 8th, 1935), *cert. denied*, 296 U. S. 615 (1935); (1936) 36 COL. L. REV. 329.

debenture holders equally if any pledge or mortgage of the property is subsequently made, or its equivalent, a promise not to pledge or mortgage to others without ratably securing the debenture holders, has been regarded as an affirmative covenant giving rise to a valid present interest in the property.[42] Under these cases, Judge Mack might easily have considered the covenants in the *Kelly* case as being affirmative, and giving rise to an equitable lien.[43] Alternatively, several courts, shifting the emphasis, have enforced what they called equitable liens on property on the ground that when the underlying contract to give security was enforceable in equity, the promisee has an interest like a lien in the property which he might have had appropriated to secure his promise.[44] This view of an equitable lien, inferred from a right to equitable enforcement of a contract for security, requires that the contract be in fact enforceable in equity before the lien can be recognized: that is, plaintiff must show that his remedy at law on the promise is inadequate. Judge Mack in the *Kelly* case considered the acceleration clause in the debenture, which might have been enforced in the event of a breach while the issuer was solvent, as an adequate remedy at law, precluding both an injunction against breach and the recognition of an equitable lien based on the right to an injunction. In the *Sweezy* case, a lien in favor of the debenture holders was enforced, under circumstances almost identical with the state of facts in the *Kelly* case, by construing the covenant as being both affirmative and enforceable by equitable remedies. Circumstances which Judge Mack regarded as providing an adequate remedy at law—the possibility of acceleration while the issuer was still solvent[45]—were there directly held not to bar injunctive relief.[46]

Whatever the nature of the lien, it is commonly said that an equitable lien is enforceable only against those who take assets subject to the lien with knowledge of the contract underlying the lien.[47] The plaintiff in the *Kelly* case attempted to charge the defendant banks with knowledge of the

42. Connecticut Co. v. New York, N. H., & H. R.R., 94 Conn. 13, 107 Atl. 646 (1919); Chase Nat. Bank v. Sweezy, 281 N. Y. Supp. 487 (Sup. Ct., 1931), *aff'd*, 261 N. Y. 710, 185 N. E. 803 (1933).

43. The *Sweezy* case is not discussed by Judge Mack in its bearing upon the possible affirmative construction of the conditional negative pledge in the *Kelly* case. The two cases reach opposite results on substantially identical covenants.

44. McMurray v. Moran, 134 U. S. 150 (1890); Great Lakes & St. Lawrence Transp. Co. v. Scranton Coal Co. 239 Fed. 603 (C. C. A. 7th, 1917).

45. 11 F. Supp. 497, 511 (S. D. N. Y. 1935).

46. There was an acceleration clause in the *Sweezy* case, quoted *infra*, note 52, but since it was not stated in the opinion the holding of the *Sweezy* case on this point was misconstrued in the *Kelly* case. Comment (1936) 49 HARV. L. REV. 620, 624.

47. McMurray v. Moran, 134 U. S. 150 (1890); Wilson v. Kelland [1910] 2 Ch. 306. See Tobin v. Insurance Agency Co., 80 F. (2d) 241, 243 (C. C. A. 8th, 1935); Valley State Bank v. Dean, 97 Colo. 151, 156, 47 P. (2d) 924, 927 (1935); McFerran v. Louisville Title Co.'s Rec'r, 254 Ky. 362, 366, 71 S. W. (2d) 655, 657 (1934); 1 JONES, LIENS (3rd ed. 1914) § 1048.

negative pledge clause in several ways. It was shown that the banks subscribed to Moody's Manuals which contained descriptions of the debentures and their terms, that there were in the credit files of the banks copies of annual statement of I. U. I. which revealed the existence, though not the terms of the debentures, and that most of the banks held some of these debentures in trust accounts or as collateral for brokers' loans.[48] However, since Judge Mack found organic difficulties in the way of establishing an equitable lien, he did not think it necessary to pass upon the question of knowledge. Upon appeal, the Circuit Court of Appeals remanded the case and requested that the lower court pass upon the question of whether the banks had knowledge of the restrictive covenants in the bond debentures.[49] It is a reasonable inference from this decision that the Circuit Court of Appeals disagrees with Judge Mack's holding that an equitable lien did not exist; for the issue of knowledge becomes relevant in this connection only when the attempt is made to enforce an acknowledged lien.

Since it would be very difficult to prove actual knowledge in the case of a large bank, it could reasonably be held that the circumstances surrounding the granting of a loan by such a bank raise a presumption of knowledge, not only of the existence of the debentures, but also of restrictive covenants contained in them.[50] The availability of balance sheets which would indicate the existence of debentures, and the usual practice of carefully examining such documents before extending credits, the listing of the terms of restrictive covenants in financial manuals, and all the facilities of a well-organized credit department, create so favorable an opportunity for a bank to learn the existence and terms of these covenants, that it can hardly claim protection as an innocent holder.

It is true that an initial decision imposing liability on pledgees would appear to inflict a heavy penalty on the immediate defendant in order to impose a

48. 11 F. Supp. 497, 502 n. 5 (S. D. N. Y. 1935).

49. Kelly v. Central Hanover Bank & Trust Co., 85 F. (2d) 61 (C. C. A. 2d, 1936).

50. Suggestions of such a presumption appear in several recent cases. "Therefore, in the conclusions here reached, I have taken as the knowledge of the defendant on the date of the substitution, the sum total of all the knowledge and information which its various officers themselves had, as officers, and also the material which was contained in the various credit and investment files of the bank on that date." Hazzard v. Chase Nat. Bank, 159 Misc. 57, 75, 287 N. Y. Supp. 541, 561 (Sup. Ct. 1936). "The defendant sought to prove that some of its officials who were in charge of its trust department had no knowledge of the fact that it was a creditor of the debtor and was receiving money from the latter and also that it had property of the latter in its possession. It was not established that there was not someone connected with the defendant who knew all of these facts . . . " Starr v. Chase Nat. Bank, N. Y. L. J. September 21, 1936, p. 77' col. 6 (Sup. Ct.) ". . . the party taking the security was the very bank which, as trustee under the indenture, must be held to have had actual knowledge of its terms." Chase Nat. Bank v. Sweezy, 281 N. Y. Supp. 487, 491 (Sup. Ct. 1931), *aff'd*, 261 N. Y. 710, 185 N. E. 803 (1933). See also Comments, (1935) 30 ILL. L. REV. 487, 489; (1936) 36 COL. L. REV. 658. Knapp v. Bailey, 79 Me. 195, 9 Atl. 122 (1887); Earl of Sheffield v. London Joint Stock Bank, 13 A. C. 333 (1888). *Contra:* English & Scottish Mercantile Co. v. Brunton [1892] 2 Q. B. 700; *In re* Valletort Sanitary Steam Laundry [1903] 2 Ch. 654.

rule that knowledge will be presumed, but it is only by the imposition of such penalties in initial cases that legal growth takes place. Nor should it be overlooked that, if debenture holders are denied recovery against creditor pledgees, the rule established, *i.e.*, that the purchaser of debentures should read carefully the restrictive covenants, that he should realize that, in view of the difficulty of establishing actual knowledge, he can probably recover for violation only against the issuer, and therefore that he should keep in close contact with all the business operations of the issuer so that he will know when to sue, can have little actual effect upon future conduct. On the other hand, if a bank is heavily penalized once for taking a pledge in violation of a covenant, other banks and their lawyers may reasonably be expected to take adequate precautions in all future loans to corporations which have outstanding debenture issues.

If a trustee has been provided to assert the rights of the debenture holders under negative pledge or 50% clauses, the methods by which debenture holders' rights may be asserted are somewhat changed. The problems of proving violation of the covenants, the doctrinal difficulties with equitable liens, and the necessity for a presumption of knowledge, remain as stated above, but the power to sue is vested in the trustee rather than in the individual debenture holders.[51] The trustee may be given power to accelerate the debentures upon default or violation of the covenants, but is ordinarily under no duty to do so unless such action is required by a specified percentage of the debenture holders.[52] It may sue to collect the debentures or to enforce their covenants and is required to do so upon the request of a percentage of holders and a proffer of indemnity for the expenses of suit.[53] Only after refusal of the trustee to act after proper request may an individual holder do so.[54] These requirements of unified action by a percentage of holders and

51. Gardiner, *loc. cit. supra* note 8. DEWING, *op. cit. supra* note 3, at 80.

52. The record before the New York Court of Appeals in Chase Nat. Bank v. Sweezy, 261 N. Y. 710 (1933) contains an example of this type of indenture at p. 445. It reads, p. 460, "If one or more of the following events, herein called the events of default, shall happen [six conditions, including default of interest for 30 days or of principal and non-performance of covenants for 60 days, are then listed] . . . the Trustee may, and upon the written request of the holders of a majority in amount of the bonds . . . it shall, declare the principal of all the bonds to be immediately due and payable." QUINDRY, *op. cit. supra* note 3, § 138.

53. *Id.* at 463. "If the Company shall fail after written demand therefor by the Trustee to pay forthwith any amounts due from the Company, . . . the Trustee . . . shall be entitled to, and upon the written request of the holders of not less than 25% in amount of the bonds . . . and upon being furnished with indemnity satisfactory to it . . . it shall, institute such proceedings at law or equity as may be necessary for the collection of the sums so due and unpaid, and/or for specific performance of this Indenture or other appropriate relief." QUINDRY, *op. cit. supra* note 3, § 200.

54. *Id.* at 465. "No holder of any bond or coupon issued hereunder shall have the right to institute any suit . . . unless such holder shall previously have given to the trustee written notice of any existing default and of the continuance thereof as herein provided, nor unless, also, the holders of not less than twenty-five percent in amount

request to the trustee may often result in delay as or greater than that in cases where there is no trustee. Since the trustee is under no duty to act upon its own initiative, and since it may not be advised of the violation in sufficient time, it is not likely to bring suit against the issuer to enjoin breach,[55] or to recover after breach and before insolvency. If then the sole remedy is that against pledgees, the trustee is in no better legal position to pursue this remedy than are the individual holders. These holders may, however, recover in certain cases against the trustee. In the recent case of *Starr v. Chase National Bank*[56] the failure of the trustee to act to protect noteholders after default was held to impose liability upon the trustee on the ground that the duties of the trustee became active upon default of interest, in spite of the fact that the trustee was, under the indenture, under no duty to act unless requested to do so, and was exempted from all liability for anything except gross negligence or bad faith. If this rule could be applied where the default consisted of violation of a restrictive covenant, then when the trustee failed to act with reasonable diligence the debenture holders might recover from the trustee in spite of exculpatory clauses. If in addition the trustee became a pledgee at the time of violation of the covenants, the debenture holders may clearly share in this pledge.[57]

If the trustee has knowledge of circumvention of the protective intent of restrictive covenants through the subsidiary device used by Cuban Cane and Paramount-Publix,[58] a device likely to become increasingly familiar if the

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of the bonds then outstanding shall have made written request upon the Trustee, . . . nor unless, also, such holders shall have offered the Trustee security and indemnity, satisfactory to it . . . , and the Trustee shall have refused or neglected to comply with such request within a reasonable time thereafter." QUINDRY, *op. cit. supra* note 3, §§ 89, 117.

55. It would appear that, under the quoted indenture, not even the trustee could sue to enjoin breach until after the debentures had been matured. The clause cited in note 53 *supra*, provides only for suit after failure of the Company to pay an amount due, and breach of a covenant might well occur without any such failure of payment. *Quaere* whether this provision would prevent a court of equity from granting an injunction against threatened breach.

56. N. Y. L. J., September 21, 1936, p. 771, col. 6 (Sup. Ct.).

57. Chase Nat. Bank v. Sweezy, 281 N.Y. Supp. 487 (Sup. Ct. 1931), *aff'd*, 261 N.Y. 71, 185 N.E. 803 (1933); Kaplan v. Chase Nat. Bank, 156 Misc. 471, 281 N.Y. Supp. 82 (Sup. Ct. 1934). No exculpatory clauses appeared in these cases, but if the technique of Hazzard v. Chase Nat. Bank, 159 Misc. 57, 287 N.Y. Supp. 541 (Sup. Ct. 1936), were followed in similar cases where the trustee is exempted such clauses would not alter the result. This technique imposed the knowledge of all the officers, directors, and files of the corporation upon the corporation, 159 Misc. 57, at 75, 287 N.Y. Supp. 541, at 561, and then applied the exculpatory clauses only to the duties which should arise from such knowledge. Since participating in a pledge with knowledge of the negative pledge clauses would subject the trustee to an equitable lien, there would be no question of duty which the exculpatory clauses might alleviate.

58. The trustees of the debenture issues in both these cases were informed of the subsidiary transaction, and did nothing, if indeed they could have, to protect the debenture holders. S. E. C., *op. cit. supra* note 6, at 13, 98-99.

possibilities of recovery against pledgee and trustee outlined above are realized, the trustee would be liable only if the transfer to subsidiaries is held to violate the negative pledge clause.[59] But if the courts sustain the use of the transfer to a subsidiary to circumvent a negative pledge clause, it is difficult to see upon what basis any liability could be imposed upon a trustee for its acquiescence in such a scheme.

Where debentures are secured by the deposit of collateral with a trustee, the rights of the debenture holder rest upon the nature of the trustee's duties with respect to the preservation of the collateral, and upon the remedies against the trustee for failing to perform these duties. These rights would seem to be as illusory as those conferred by restrictive covenants. In the recent case of *Hazzard v. Chase National Bank*[60] the holders of a $10,000,000 debenture issue of the National Electric Power Company, an Insull subsidiary, sued the trustee for allowing the issuer to substitute worthless holding company stock for the operating company stock originally deposited. The trust indenture, however, expressly provided for the substitution of other stock upon the certificate of the issuer as to earnings of the stock to be substituted.[61] Although the trustee was given the power to investigate independently, no such duty was imposed upon it and it could if it chose treat these earning certificates of the issuer as conclusive on their face. The indenture further exempted the trustee from liability for the negligence of any of its agents or for any contingency except its own gross negligence or bad faith.[62] Officers of the issuer were heavily indebted to the Chase National Bank; the bank was represented on the board of directors of the issuer and was the largest single creditor of the issuer. Judge Rosenman, after commenting upon the inconsistency of the position of the Chase Bank as a creditor of the issuer and as trustee under the indenture, was reluctantly forced to hold that the plaintiffs could not recover from the bank for its negligence in permitting the withdrawal and substitution. Even assuming that all the knowledge that Chase Bank gained by virtue of its various conflicting positions were imputed to it as trustee, Judge Rosenman felt bound to hold that by acting within the terms of the indenture the Chase Bank had successfully avoided the liability which would undoubtedly have attached in the absence of the exemption clause. Judge Rosenman commented upon the unrealistic nature of the legal rule which holds purchasers of such a debenture issue to a knowledge of the precise terms of the indenture as though it were a simple contract.[63] Notwithstanding the unfairness of giving effect to exculpatory clauses in indentures, he felt that the rule was too well settled to be changed by the courts and urged that it be changed by legislation.

59. See notes 30, 31 *supra*.
60. 159 Misc. 57, 287 N. Y. Supp. 541 (Sup. Ct. 1936).
61. *Id.* at 60, 62, 287 N. Y. Supp. at 545, 547.
62. *Id.* at 62, 287 N. Y. Supp. at 546.
63. *Id.* at 83, 287 N. Y. Supp. at 569.

A similar situation was revealed by a Senate Committee Investigation of the Kreuger and Toll crash.[64] A $50,000,000 debenture issue was secured by the deposit of bonds with a trustee, but the indenture provided for substitution of other bonds within specified categories and on the basis of par value rather than market value. The trustee was permitted by the indenture to rely solely upon the certificate of the Kreuger and Toll Company as to the eligibility of the bonds to be substituted. Shortly before the collapse of the entire corporate structure the trustee permitted a substitution of bonds whose market value, at the time of the Senate hearings, was only two-fifths of those originally deposited. The fact that the inferior bonds were technically eligible under the indenture did not mitigate the loss of the debenture holders, but merely precluded any recovery by them against the trustee.

The rule that the terms of the trust indenture are binding upon debenture holders seems firmly established.[65] When it is combined with a power of substitution of collateral by the issuer which the trustee may permit by relying on an earnings statement submitted by the issuer, the opportunity for rendering the collateral of little value is complete. If the substitution is performed carelessly, so that the terms of the debenture are not followed, the trustee is liable.[66] The trustee usually has power to make careful inquiries and act to protect debenture holders, but is under no duty to do so.[67] It is protected by the exculpatory clauses of the indenture even from liability for failing to prevent an observed substitution of worthless security according to legal forms.[68] It may be that the occurrence of actual default would give rise to active duties.[69] It is probable that if the trustee actually participates in the benefits of the withdrawal by taking a lien on the withdrawn security it is liable.[70] It apparently is not so liable where it may possibly have benefited from the substitution because of its position as a large unsecured creditor of the issuer.[71]

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64. SEN. REP. No. 1455, 73d Cong., 2d Sess. (1934) 121–123, reported in S. E. C., *op. cit. supra* note 6, at 16.

65. Browning v. Fidelity Trust Co., 250 Fed. 321 (C. C. A. 3rd, 1918), *cert. denied*, 248 U. S. 564 (1918); Benton v. Safe Deposit Bank, 255 N. Y. 260, 174 N. E. 648 (1931); Hazzard v. Chase Nat. Bank, 159 Misc. 57, 287 N. Y. Supp. 541 (Sup. Ct. 1936).

66. Doyle v. Chatham & Phenix Nat. Bank, 253 N. Y. 369, 171 N. E. 574 (1930).

67. Hazzard v. Chase Nat. Bank, 159 Misc. 57, at 71, 287 N. Y. Supp. 541, at 557 (Sup. Ct. 1936).

68. *Id.* at 82, 287 N. Y. Supp. 541, 569.

69. Starr v. Chase Nat. Bank, N. Y. L. J., September 21, 1936, p. 771, col. 6. The difficulty with this rule is that the substitution of worthless securities and the withdrawal of valuable ones is likely to be done, as in the *Hazzard* and *Kreuger and Toll* cases, to stave off default.

70. Guaranty Trust Co. v. Atlantic Coast Electric R. R., 138 Fed. 517 (C. C. A. 3rd, 1905); Marshall & Ilsley Bank v. Guaranty Inv. Co., 213 Wis. 415, 250 N. W. 862 (1933).

71. In the *Hazzard* case, the Chase Bank was the largest single creditor of the issuer, and obtained security on many of its loans six months prior to the withdrawal.

The judges who tried the *Hazzard* and the *Kelly* cases both concluded that legislation was necessary if debenture holders are to be given the protection which covenants in their debentures purport to assure.[72] To be completely effective, any such scheme of legislation would probably require action both by Congress and by the states chiefly concerned with the business of finance, unless the Supreme Court treats national powers more generously with respect to securities regulation than to the national regulation of poultry marketing or coal mining. Federal legislation, possibly by way of amendment to the Securities Act of 1933,[73] could establish general limitations on the terms of issuance of such securities; state statutes, without going so far as to burden the interstate commerce in securities, could regulate the detailed practices normally referable to local law.[74] This comment will be concerned only with a definition of aims for possible federal legislation in

159 Misc. 57, 63, 287 N.Y. Supp. 541, 548. This freezing of assets may have necessitated the subsequent withdrawal, but it was not considered relevant to the decision.

72. Kelly v. Central Hanover Bank & Trust Co. 11 F. Supp. 497, 514 (S.D.N.Y. 1935); Hazzard v. Chase National Bank, 159 Misc. 57, 85, 287 N.Y. Supp. 541, 571 (Sup. Ct. 1936).

73. 48 STAT. 74 (1933) as amended by 48 STAT. 905 (1934); 15 U.S.C. § 77 (1935 Supp.). The S.E.C. might undertake measures looking to reform under § 19 of the Securities Exchange Act of 1934 [48 STAT. 881, 898 (1934), 15 U.S.C. § 78s (1935 Supp.)] permitting it to prescribe the listing requirements for securities traded on national exchanges. As the S.E.C. Report points out (S.E.C. *op. cit. supra* note 6, at 110) such action would have the disadvantage of not reaching securities not traded on the exchanges, and perhaps of inducing issuers to keep such issues off the exchanges. There may be disadvantages too in singling out debentures for severe administrative regulation in advance of a general regulation of the contract terms of securities. See also PUB. UTIL. HOLDING COMPANY ACT, § 7, 49 STAT. 838, 15 U.S.C. § 79g (1935 Supp.).

74. The Streit Act, for example, recently passed in New York (L. 1936, c. 900, amending L. 1909, c. 52, REAL PROPERTY LAW, Art. 4A) makes rules and defines standards in a comprehensive program to control the management of mortgage investments secured by New York real estate, or administered by a trustee, bondholders' protective committee, depositary, management company, voting trustee, or other person who has an office for the transaction of business with respect to the mortgage investment within New York, or has obtained authority to do business within the state. The Streit Act meets many of the objections brought by the S.E.C. against the administration of investments by trustees (REPORT OF THE S.E.C., *op. cit. supra* note 6, III, REAL ESTATE BONDS 4–35, 229, and *passim;* VI, TRUSTEES UNDER INDENTURES 110–111). State legislation of a similar type could do much to accomplish the same ends, although it would be less effective both from the point of view of administrative efficiency and of geographical completeness than national regulation. The present power of some state securities commissions to refuse to authorize the sale of any security which in their opinion will work a fraud upon the purchaser thereof, CAL. GEN. LAWS (Deering, Supp. 1935) Act 3814, § 4; MICH. COMP. LAWS (1929) § 9780 as amended by Pub. Acts, 1935, No. 37, provides an adequate basis for further legislation similar to the proposed amendments to the Securities Act. See Klagsbrunn, *Regulation of Interstate Security Sales—A Recent Report* (1933) 1 U. OF CHI. L. REV. 88; Washburn & Steig, *Control of Securities Selling* (1933) 31 MICH. L. REV. 768.

this field, not with the administrative and constitutional problem of distributing powers between state and national agencies of control, or the draftsman's problem of fitting a new statute into the existing pattern of statutes and decisions.

Under the present Securities Act, the powers of the Securities and Exchange Commission are probably inadequate to reform usage with respect to covenants in debentures. The Commission has authority under the Act to refuse to permit a registration statement to become effective[75] or, after a hearing, to issue a stop order suspending the effectiveness of a registration statement for the misstatement or omission of a material fact. None of the administrative interpretations so far made by the S. E. C. suggest that the inclusion in a debenture of covenants such as those proven illusory in the *Kelly* and *Hazzard* cases would be regarded as misleading within the prohibition of § 8 (d); but such a result is probably justified by the act. In their usual form, such covenants in debentures can be classified with the suspected provisions of those registration statements whose effectiveness the S. E. C. has suspended on the ground that they convey a false or misleading impression of safety,[76] both for reasons of unintelligibility, and because they often enhance the attractiveness of securities by promising the investor more than he can be given.[77] Thus it might be possible to deny registration to a debenture issue in one of the orthodox forms as misleading, in that it contains promises easily evaded.

But even if the S. E. C. could now assure the investor that the debenture provisions purporting to protect him would be written unambiguously, it could hardly go so far as to outlaw such covenants altogether.[78] The first job of the Securities Act is to require publicity, and while the S. E. C. can force the disclosure of material facts, it is without authority to pass upon the investment quality of securities or remake the habits of the financial community. Without altering the function of the S. E. C., it should be possible to protect investors by requiring all debentures to comply with certain requirements of safety before registration can be effective. A legislative scheme to meet some of the general difficulties dramatized in the recent conflict as to covenants in debentures might be set up somewhat as follows:[79]

A debenture issue containing no restrictive covenants or provisions for the deposit of collateral should be permitted registration under terms similar

75. 48 STAT. 74 (1933) as amended by 48 STAT. 905 (1934), 15 U. S. C. § 77h (b), (d) (1934).

76. *In re* Oil Ridge Oil and Refining Co., S. E. C. Release No. 522, Oct. 15, 1935. *In re* Franco Mining Corp., S. E. C. Release No. 650, February 5, 1936. *Cf.* Comment (1936) 45 YALE L. J. 1076, 1097–1098.

77. S. E. C. *op. cit. supra* note 6, at 11.

78. As is suggested as one solution of the problem, S. E. C. *op. cit. supra* note 6, 11.

79. These suggestions rely heavily on the thorough and vigorous REPORT OF THE S. E. C., *op. cit. supra* note 6, and on the conclusions which have so far been formulated in it.

to those imposed upon all securities by the Securities Act. The total lack of contractual protection in such debentures would be frankly acknowledged instead of masqueraded behind futile and illusory restrictive covenants or trust indentures. This type of debenture would permit the issuer the greatest possible freedom in the handling of its assets, and would direct the attention of investors to an analysis of going concern values, instead of to ephemeral rights in liquidation.

The registration statement for a debenture issue which contains restrictive covenants, however, should not be accepted until the following conditions are satisfied. (1) To avoid strained interpretations of the existing statute, the S. E. C. should be given explicit power to refuse registration, or to issue a stop-order suspending the effectiveness of registration, if it deems covenants to be ambiguous, or capable of obvious evasion.[80]

While this authority in the S. E. C. might be exercised to some effect, it is naive to suppose that such protection is alone adequate. Granted the mores of the financial community and the fertile imagination of counsel, as reflected in the debenture cases discussed above, it is safe to prophesy that any debenture covenant, no matter how clear superficially, will be evaded to the discomfiture of the debenture holder if he has to depend for protection on litigation brought by himself to remedy breaches of the covenants, rarely discovered until long after the event. Thus (2), no debenture issue containing restrictive covenants should be allowed registration unless it provides that a trustee be appointed to protect the rights of the holders.[81] The first phase of this effort should be to make sure that the trustee appointed for the position be in fact a trustee; trustees should be disqualified strictly if they have interests incompatible with their fiduciary role.[82] The second effort should be to require such trustees to exercise both care and energy in the interests of the debenture holders. The duties of the trustee should be to make the restrictive covenants effective by actively pursuing any cause of action arising under them in favor of debenture holders, regardless of

80. The S. E. C. recommends such a provision, REPORT, *op. cit. supra* note 6, at 111. State Blue Sky Laws often contain analogous provisions. *Cf.* note 74, *supra*. For a collection of state laws, see THORPE AND ELLIS, FEDERAL SECURITIES ACT MANUAL (1933) § 147, 132 C. C. H. ¶ 5503–5984.

81. The S. E. C. REPORT recommends either the abolition of negative pledge clauses in debentures, or their enforcement by a trustee given more definite responsibility "for the adequacy of . . . protective features" *op. cit. supra* note 6, at 11, 16.

82. Thus in Starr v. Chase Nat. Bank, N. Y. L. J., September 21, 1936, p. 771, col. 6 (Sup. Ct. 1936), the trustee under the indenture was also a creditor of the issuer, and sought to satisfy its claim against the issuer without any effort to protect the interests of the debenture holders. For further instances of inconsistent interests of trustees, see Hazzard v. Chase National Bank, 159 Misc. 57, 63, 287 N. Y. Supp. 541, 548 (Sup. Ct. 1936). Posner, *Liability of the Trustee under the Corporate Indenture* (1928) 42 HARV. L. REV. 198, 226. *Cf.* STREIT ACT (note 74, *supra*) § 127; S. E. C. REPORT, *op. cit. supra* note 6, 71–109.

whether or not any request to do so be made by a holder. A vigilant and active trustee would make available the remedies of injunction against a contemplated breach of covenant and/or recovery at law from the issuer before insolvency. Clauses exempting trustees from liability should prevent registration,[83] and it should be provided that only trustees of sufficient financial responsibility to meet the needs of the particular issue may be selected. Although there are some differences in detail, the recent proposals looking to reform in the conduct of trustees under indentures emphasize the same elements as essential to an effective code for trustees.[84] The trustee must be made an active trustee, and given specific duties. Although the imposition of active duties and liability for ordinary negligence upon the trustee would make necessary higher fees for this type of service, the debenture holders would be getting fiduciary protection, as Judge Rosenman pointed out in the *Hazzard* case.[85]

(3) A further change, though one less generally supported than the proposals for the reform of trustee's conduct under indentures, relates to the effect of an effective registration statement as notice. It is suggested, though with reservations, that registration of the issue with the S. E. C. should be considered a presumption of notice of the terms of negative pledge clauses to all who deal with the issuing corporation.[86] This may seem an unnecessary precaution if an active and financially responsible trustee is answerable for the performance of the covenants, but unless the trustee is made an insurer, there may arise cases in which it would be desirable that an effective cause of action against third parties be available to debenture holders. Suppose that an issuer succeeds in pledging assets as collateral for a bank loan, for

83. For discussion, see Hazzard v. Chase National Bank, 159 Misc. 57, 80, 287 N. Y. Supp. 541, 566 (Sup. Ct. 1936); and Payne, *Exculpatory Clauses in Corporate Mortgages and other Instruments* (1934) 19 CORN. L. Q. 171; Comment (1933) 33 COL. L. REV. 97; S. E. C. REPORT, *op. cit. supra* note 6, at 67–70.

84. Most conspicuously the S. E. C. REPORT, *op. cit. supra* note 6, at 110–111; Streit Act, (note 74, *supra*) § 126. The Streit Act does not in terms forbid clauses limiting the liability of trustees.

85. Hazzard v. Chase National Bank, 159 Misc. 57, 84–85, 287 N. Y. Supp. 541, 571 (Sup. Ct. 1936).

86. It may be difficult to provide for such consequences of registration for only one class of security; perhaps, however, the publicity now attending registration will in the future make the proof of actual knowledge easier as to all facts contained in registration statements, without statutory presumptions, at least as to persons, like bankers, whose business it is to know the affairs of their customers. *Cf.* p. 106 *supra*. Registration of debentures under the English Companies Act 1900, 63 & 64 VICT. c. 48, while notice of the floating charge, was held not to be notice of the restrictive covenants. *Re* Standard Rotary Machine Co., 95 L. T. 829 (Ch. D. 1906); Wilson v. Kelland [1910] 2 Ch. 306 (Ch. D.); G. & T. Earle, Ltd. v. Hemsworth R. D. C., 44 T. L. R. 605 (K. B. Div., 1928) *aff'd* 44 T. L. R. 758 (C. A. 1928). A specific statement that registration was notice of the restrictive covenants would cure this defect.

example, in violation of a covenant, despite the diligence of the trustee. A difficulty barring such action has been the proof of the pledgee's actual knowledge of the terms of the covenant allegedly breached by the pledge.[87] Since it is inconceivable that large banking institutions about to make a substantial loan to a corporation do not discover, in the process of credit investigation, the terms of a borrower's outstanding issues, and base the loan in part on an assessment of their legal consequences, it does not seem unreasonable to presume such knowledge on the part of the pledgee, so that recovery of the pledged assets by the debenture holders can be supported on orthodox grounds. The filing of registration statements for debentures with the S. E. C. in Washington and with the regional offices throughout the country would make the terms of negative pledge clauses reasonably accessible. Such a presumption should minimize the difficulty of proving actual knowledge in these cases. It remains to be seen whether Judge Mack will find in the peculiar circumstances of the *Kelly* case[88] that the pledgee banks actually knew of the negative pledge clauses in the debentures. Other cases have inferred actual knowledge rather freely,[89] and it may be that a statutory presumption is unnecessary to achieve the end sought.

When the nature of the issuer's business makes it feasible to deposit assets with a trustee, as security for a debenture, registration should be withheld unless the trust indenture complies with the following conditions: the terms of deposit should be defined, and the nature of the collateral specified. Substitution should only be permitted with the approval of the trustee, when the substituted collateral satisfies stated criteria of equivalence as to market value and earnings history. No exculpatory clauses in favor of the trustee should be permitted.

The effect of imposing these conditions upon the registration of debenture issues containing restrictive covenants or collateral trust indentures is to put the S. E. C. in a position to bargain effectively for the debenture holders, instead of permitting their rights to be determined, as they are today, by the adversely interested issuer and trustee. A legislative scheme sufficiently comprehensive to protect debenture holders by providing for the adequate enforcement of restrictive covenants and collateral trust agreements might seem unduly to restrict an issuer in the control and disposition of its assets. Strict enforcement of such restrictions may even impair the protective qualities

87. *Cf.* p. 106 *supra.*

88. *Ibid.*

89. Hazzard v. Chase National Bank, 159 Misc. 57, 75, 287 N.Y. Supp. 541, 561 (Sup. Ct. 1936) (Knowledge imputed to trustee is "the sum total of all the knowledge and information which its various officers themselves had, as officers, and also the material which was contained in the various credit and investment files of the bank on that date"). *Cf.* Kelly v. Central Hanover Bank & Trust Co., 11 F. Supp. 497, 502, n. 5 (S.D.N.Y. 1935) (virtually identical circumstances); Starr v. Chase National Bank, N. Y. L. J., September 21, 1936, p. 771, col. 6 (Sup. Ct. 1936).